

Does Economic Growth Affect Capital Market Development In Nigeria? 1985 – 2016.

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ABSTRACT: The goal of this paper is to assess the impact of economic growth affects capital market development in Nigeria using annualised data from 1986-2016. We employed that Johansen cointegration technique to determine if our variables are cointegrated. The error correction model (ECM) was employed to estimate our dynamic short and long-run model. Various diagnostic tests were also conducted to confirm the validity of our results. The results indicate that there is a long-run relationship between economic growth and capital market development. The baseline estimator further showed that economic growth has significant positive influence on capital market development. We also found that inflation has significant negative impact on the capital market while money supply was found to have insignificant effect on the dependent variable. The error correction term showed evidence of slow speed of adjustment toward long-run equilibrium, with deviation from equilibrium corrected at the speed of 2.3 percent on annual basis. We conclude that economic growth indeed drives capital market development in Nigeria. And were recommend that policies aimed at facilitating economic activities should be pursued by the monetary authorities, the government and policymakers to further enhance the development of Nigerian capital market.

KEYWORDS: *Economic growth, capital market, error correction model*

I. INTRODUCTION

Alile (1998) describes the capital market as the major vehicle (or mechanism) for mobilizing long-term funds for investment purposes. The Nigerian economy has generally been growing over time, just as the Nigerian capital market. The challenge, which this work is intended to undertake, is to determine the influence of the nation's economic growth on the development of the capital market, which was established in 1961 to provide and sustain the capital requirements of the Nigerian economy, in the growth matrix.

These arguments on the importance of stock market development in the growth process are supported by various empirical studies, such as Levine and Zervos (1993, 1996, and 1998); Atje and Jovanovic (1993), and Demirguc-Kunt (1994). Filer, *et al.* (1999) find that an active equity market is an important engine of economic growth in developing countries. Rousseau and Wachtel (2002) and Beck and Levine (2002), show that stock market development is strongly correlated with growth rates of real GDP per capita, and that stock market liquidity and banking development both predict the future growth rate of the economy when they both enter the growth regression.

Stock exchanges exist for the purpose of trading ownership rights in firms, and are expected to accelerate economic growth by increasing liquidity of financial assets, making global risk diversification easier for investors, promoting wiser investment decisions by savings-surplus units based on available information, compelling corporate managers to work harder in shareholders' interests, and channeling more savings to corporations (Greenwood and Jovanovic, 1990 and King and Levine, 1993). In accord with Levine (1991), Bencivenga, *et al* (1996) emphasise the positive role of liquidity provided by stock exchanges on the size of new real asset investments through common stock financing. Investors are more easily persuaded to invest in common stocks when there is little or no doubt on their marketability in stock exchanges. This, in turn, motivates corporations to go public when they need more finance to invest in capital goods.

Stock prices determined in exchanges, and other publicly available information, help investors make better investment decisions. Better investment decisions by investors mean better allocation of funds among corporations and, as a result, a higher rate of economic growth. In efficient capital markets, prices already reflect all available information, and this reduces the need for expensive and painstaking efforts to obtain additional information (see, Stiglitz, 1994).

On a broader scope on the debate on whether financial development engenders economic growth or whether financial development is consequential upon increased economic activity, Schumpeter (1912) opined that technological innovation is the force underlying long-run economic growth, and that the cause of innovation is the financial sector's ability to extend credit to the "entrepreneur" (Filer, et al, 1999) while Robinson (1952) claims that it is the growth of the economy that causes increased demand for financial services which, in turn, leads to the development of financial markets. Thus, this study seeks to fill this knowledge gap, that is, to explore the impact of capital market development on Nigeria's economic growth from the demand-following argument that it is the growth of the Nigerian economy that has promoted the development of the capital market.

II. LITERATURE REVIEW

Stock markets in developing countries have become so increasingly important over the last few decades that researchers have been exploring the relationship between stock market development and economic growth, motivated by the policy implications of their findings for the developing economies, according to Deb and Mukherjee (2008), who find causality running from the financial sector to the real sector of the Indian economy between 1996 and 2007. Nowbutsing and Obit (2009) analyse the relationship between stock market development and economic growth in Mauritius from 1989 to 2006 and find that the positive relationship between stock market development and economic growth in the long run was replicated in the short run also. Osei (2005) find causality running from stock market development to economic growth in Ghana.

At the firm level, stock market's ability to effect changes in the management of listed companies is expected to ensure that managerial resources are used efficiently (Morck, et al 1990a). Greenwood and Smith (1996) show that large stock markets can lower the cost of mobilizing savings and, thereby, facilitate investment in the most productive technology. Levine (1991) and Bencivenga, et al (1996) argue that stock market liquidity, that is, the ability to trade equity easily and cheaply, is more important for growth. Although many profitable investments require a long-run commitment of capital, savers do not like to relinquish control of their savings for long periods. Liquid equity markets ease this tension by proving an asset to savers that they can quickly and inexpensively sell. Simultaneously, firms have permanent access to capital raised through equity issues. Holmstrom and Tirole (1993) and Kyle (1994) argue further that liquid stock markets can increase incentives for investors to get information about firms and improve corporate governance.

According to Akinlo (2008), academic literature on the relationship between financial system development and economic growth dates back to as early as the late nineteenth century when Bagehot (1873) stated that it was the development of the financial sector in England that brought about an increase in the people's access to funds that were channeled into capital projects which led to the socio-economic development of England. Schumpeter (1912) concur, when he asserted that it is the supply of credit to an entrepreneur for technological innovation, which is the force underlying long-run economic growth, that makes an entrepreneur the entrepreneur. Continuing, Schumpeter (1934) asserts that without the transfer of purchasing power to him, an entrepreneur cannot become the entrepreneur. This issue has been of great interest to, and has generated considerable debate among economists and financial experts over the years.

Filer, et al (1999) argue that an active stock market is crucial in reallocating capital in developing countries such that, in the absence of such markets, growth in low and middle income countries would be substantially lower than it could have been if such active stock exchanges were present.

Mohtadi and Agarwal (2004) argue that large stock markets lower the cost of mobilizing savings and also facilitate investments in the most productive technologies. Arestis, et al (2001), Applegarth (2004) and Osei (2005) insist that it is the development of the stock market that spurs growth in the economy but Yartey (2008) and Akinlo (2008) disagree, arguing that the level of economic activities in a country constitute the key drivers of stock market development in that country.

Liu and Sinclair (2008) and Shahbaz, *et al.*, (2008) reveal that changes in stock prices reflect real economic situation such that economic growth, through changes in levels of real economic activities, affects profitability and activity of firms. As a result, with changes in profitability prospects, expected earnings and dividends, stock prices fluctuate.

Similar studies reveal that share price fluctuations play a role in directing economic activities in the medium- and long-term. Stock prices reflect public expectations towards future economic activities. Stock markets, in other words, are forward-looking and stock prices reflect anticipations about future economic activity. If a recession is expected, for example, stock prices reflect this by decreasing in value whereas large increase in stock prices may reflect expectations towards future economic growth (Jefferis and Okeahalam, 2000; Nasseh and Strauss, 2000; Mauro, 2000; Shirai, 2004; Adjasi and Biekpe, 2005; Mun, *et al.*, 2008).

It is often argued that the liquidity role of the stock market stands out clearly as the most significant, among its numerous functions. (Ezeoha, *et al.*, 2009), Citing Levine (1991, 1997), they concur that without a liquid stock market, many profitable long-term investments would not be undertaken because savers may be reluctant to tie up their investments for long periods of time. The stock market mainly provides liquidity by enabling firms to raise funds through the sale of securities cheaply, easily and speedily. Through this catalyst role, the stock market is also able to influence investment and economic growth in general (Ageme, 2014).

These contentions, and the need to clarify them, prompted Gugliemo, et al (2004) to assert that the nexus of stock market development and economic growth is not universally clear and, hence, it becomes crucial to investigate this as it reveals the extent of efficiency in capital allocation of an economy and Nurudeen (2009), who, though, finds that stock market development increases economic growth in Nigeria, to posit a resort to empirical investigations to resolve the issue but none of the empirical examinations has been able to resolve the controversy.

2.2 Empirical Review

The existence of a relationship between finance and economic development has long been established by early Economists like Schumpeter (1912) and confirmed by other scholars thereafter – McKinnon (1973), Shaw (1973), King and Levine (1993), Fry (1998), Olofin and Afangideh (2008), Ujunwa and Salami (2010). Odife (2000) asserts that the role of capital markets in fostering economic growth and development must not be underestimated: But capital markets need to be properly studied, structured, nurtured and supported to be able to play such roles. On the twenty fifth anniversary of its independence, Nigeria may have a second chance to use its stock market to revitalize its economy.

Riman, et al (2008) investigate the actual existence of a link between stock market performance and economic growth in Nigeria or if stock market liquidity is merely highly correlated with some exogenous non-financial factors between 1970-2004, and find a long run unidirectional relationship between stock market and economic growth with a caveat in interpreting the unidirectional causality as other non-financial exogenous variables influence the direction of stock market development.

Schumpeter (1912) argues that financial development induces economic growth, stressing that through the services that financial intermediaries render, such as mobilizing savings, managing risks, facilitating transactions or evaluating projects, technological and economic development is stimulated. In his reasoning, technological change is the key. His idea of “creative destruction” is a process of constant replacement of old production methods and goods with better procedures, commodities and services by invention and innovation, which financial intermediaries enable (King and Levine, 1993).

Nissanke and Stein (2003) assert that the links between financial intermediation and economic growth are based on the key functions of financial systems in the saving-investment-growth nexus, which are: firstly, to act as an effective conduit for channeling funds from surplus- to deficit- units of the economy, also referred to as the ultimate savers and ultimate borrowers, respectively, by mobilizing resources and ensuring an efficient transformation of funds into real productive capital; secondly, to transform the maturity of the portfolios of savers and investors while providing sufficient liquidity to the system as the need arises; and, thirdly, to reduce risk from the system through diversification, risk-sharing and pooling. This way, a modern financial system may spur economic growth.

Empirical analysis on the links between financial development and economic growth ignored cross-border capital movements which were very limited. However, with globalisation and economic integration increasingly becoming the dominant features of the world economy, and the relatively higher returns from investments in emerging markets, international capital mobility has exploded. Private capital flows to emerging market economies have grown from close to nothing in the 1970s to US\$170 billion in the 1980s and to US\$1.3 trillion by the late 1990s (Guiso, et al 2003), an increase of 664.7% in a decade.

These developments engendered the empirical examination of the relevance or otherwise of national financial markets for growth once domestic agents have access to foreign financial markets, from a policy perspective. Jayaratne and Strahan (1996) and Guiso, et al (2003) focus on within country differences of the effects of financial intermediation in an integrated market and find that local financial development matters.

Evidences from developing countries, however, are very slim. Allen and Ndikumana (1998) examine the role of financial intermediation in an economic union, the Southern Africa Development Community (SADC) and find a positive correlation between financial development and growth of real per capita GDP for the SADC.

However, Jenkins and Thomas (1998) criticize their study for failing to take into consideration the heterogeneous nature of the economies, as far as the question of the relevance of domestic financial intermediation is concerned. Other studies have shown that the degree of financial and monetary integration among the SADC countries is still very weak (ADB 2000). By contrast, the financial sectors in the Southern African Customs Union (SACU) countries are highly integrated because of the monetary union among most member countries.

Ujunwa and Salami (2010) trace the roots of the debate on the relationship between financial development and economic growth to Schumpeter (1912), who posited that finance is paramount for economic growth such that production requires credit to materialize – aligning with Patrick’s (1966) ‘supply-leading’ hypothesis. Rosseau and Sylla (2005) find that financial development had a significant impact on business incorporations and investments in the U.S as far back as the late 18th century in their 60-year study from 1790 to 1850.

Robinson (1952) disagrees, though, arguing that it is the growth of the economy that promotes financial development. Previous studies conducted to examine the relationship between financial development and economic growth used mostly bank-based measures of financial development, (King and Levine, 1993a) but recent studies have shifted emphasis to stock market indicators (Levine and Zervos, 1996, 1998; Demirguc-Kunt and Levine, 1996a), using cross-country regression to establish causality between stock market development and economic growth.

III. DATA AND METHODOLOGY

Data for this study is collated from the Central Bank of Nigeria Statistical Bulletin for the period 1986-2016 which were used to assess the impact of economic growth on capital market development in Nigeria. Our indicator for economic growth is the GDP growth rate while capital market development is proxied by market capitalization of listed companies in relative to GDP). Inflation rate and broad money supply (% of GDP) are included in the model as control variables. The Phillips-Perron unit root test is applied in this study to test for stationarity of the series while Johansen cointegration test is used to check for long-run association among the variables. The error correction model (ECM) is employed to ascertain the impact of economic growth on capital market development in Nigeria.

Our baseline model can be expressed as,

$$CAP_t = \alpha_0 + \alpha_1GDP_t + \alpha_2INF_t + \alpha_3MS_t + \varepsilon_t \text{ ----- (1)}$$

Where, CAP= market capitalization as a percentage of GDP, GDP= growth in gross domestic product, INF = inflation rate; MS = money supply, and ε = residual.

Equation (2) can be modified to adjust for the error correction term. the error correction model is therefore expressed thus,

$$\Delta CAP_t = \beta_0 + \sum_{i=0}^n \beta_1 \Delta CAP_{t-1} + \sum_{i=0}^n \beta_2 \Delta GDP_{t-1} + \sum_{i=0}^n \beta_3 \Delta INF_{t-1} + \sum_{i=0}^n \beta_4 \Delta MS_{t-1} + \varepsilon_t \text{ --- (2)}$$

IV. RESULTS AND DISCUSSIONS

4.1 Descriptive Statistics

Table 1. Results of Descriptive Statistics

	CAP	GDP	MS	INF
Mean	11.29468	23.09705	14.48608	20.69917
Median	7.562581	19.19875	13.06393	12.16854
Maximum	39.95010	64.23759	21.29056	76.75887
Minimum	3.053461	5.285688	9.151675	0.223606
Std. Dev.	8.629898	13.64624	3.930631	19.44263
Skewness	1.320472	1.124870	0.573157	1.574500
Kurtosis	4.881651	4.191355	1.807208	4.248097
Jarque-Bera	13.58213	8.370851	3.535019	14.82052
Probability	0.001124	0.015216	0.170758	0.000605
Sum	350.1352	716.0086	449.0686	641.6742
Sum Sq. Dev.	2234.254	5586.599	463.4958	11340.48
Observations	31	31	31	31

Source: Eviews Results

Table 1 provides statistical analysis of our individual series. Market capitalization relative to GDP averaged 11.29 percent while the mean value economic growth within the period was 23.10 percent. Broad money and inflation averaged 14.49 percent and 20.70 percent respectively over the 31 year period.

4.2 Unit Root Test

Table 1. Phillip-Perron Unit root Test.

Variable	Phillip-Perron Test Statistic	Critical Value at 5%	Order of Integration
<i>GDP</i>	-8.738924	-3.196752	1(1)
<i>CAP</i>	-5.635678	-3.196752	1(1)
<i>MS</i>	-7.538761	-3.196752	1(1)
<i>INF</i>	-6.001256	-3.196752	1(1)

Source: Eviews

Table 1 shows that our have no unit root and thus are stationary. All the variables are integrated at order one, which means that they attained stationarity after first differencing. Since the series are integrated of same order, w can proceed to determine if the variables are ointegrated, using the Johansen cointegration test.

4.3 Test for Long-Run Relationship

Table 3. Johansen Cointegration Test Results

Series: CAP GDPGR MS INF

Unrestricted Cointegration Rank Test (Trace)

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.467986	52.53664	47.85613	0.0170
At most 1 *	0.450941	34.23518	29.79707	0.0144
At most 2 *	0.419446	16.84826	15.49471	0.0311
At most 3	0.036519	1.078867	3.841466	0.2990

Source: Eviews Results.

Table 3 reveals that our variables are cointegrated. This entails that the series have long-run association hence move along in the long run. The test shows that there exist three cointegrating equations.

4.4 Error Correction Model

Table 4. Result of Dynamic Estimation

Dependent Variable: D(CAP)

Method: Least Squares

Date: 01/26/18 Time: 21:36

Sample (adjusted): 1987 2016

Included observations: 30 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.163207	0.123799	-1.318326	0.1993
D(GDP)	1.936958	0.520743	3.719603	0.0010
D(MS)	0.079983	0.044706	1.789098	0.0857
D(INF)	-0.007372	0.003308	-2.228538	0.0351
ECT(-1)	-0.024772	0.009904	-2.501241	0.0193
R-squared	0.450968	Mean dependent var		0.259165
Adjusted R-squared	0.363123	S.D. dependent var		0.301227
S.E. of regression	0.240393	Akaike info criterion		0.137927
Sum squared resid	1.444718	Schwarz criterion		0.371460
Log likelihood	2.931094	Hannan-Quinn criter.		0.212636
F-statistic	5.133680	Durbin-Watson stat		1.840035
Prob(F-statistic)	0.003689			

Source: Eviews Result.

Table 4 presents the results of our dynamic model. The long-run estimation indicate that economic growth has significant and positive impact on capital market development (CAP). Money supply however does not significantly affect CAP while inflation exerts negative and significant influence on CAP. Moreover, the regressors jointly exert significant influence on the dependent variable. The error correction term is negative and has the right sign, but does not have high speed of adjustment; it shows that deviations from long-run equilibrium is corrected as the speed 2.3 percent annually. That is the speed at which convergence to equilibrium relationship is attained.

4.5 Diagnostic Tests

Table 5. Autocorrelations and Heteroskedasticity Test Results

Breusch-Godfrey Serial Correlation LM Test:			
F-statistic	0.498922	Prob. F(2,23)	0.6136
Obs*R-squared	1.247418	Prob. Chi-Square(2)	0.5360
Heteroskedasticity Test: Breusch-Pagan-Godfrey			
F-statistic	0.391416	Prob. F(4,25)	0.8128
Obs*R-squared	1.768068	Prob. Chi-Square(4)	0.7783

Source: Eviews Results

The first panel in Table 5 is the result of the serial correlation LM test which suggests that our model has no autocorrelation problem as also indicated by the Durbin-Watson value in Table 4. The second panel further shows that our model is homoscedastic, which is a good result.

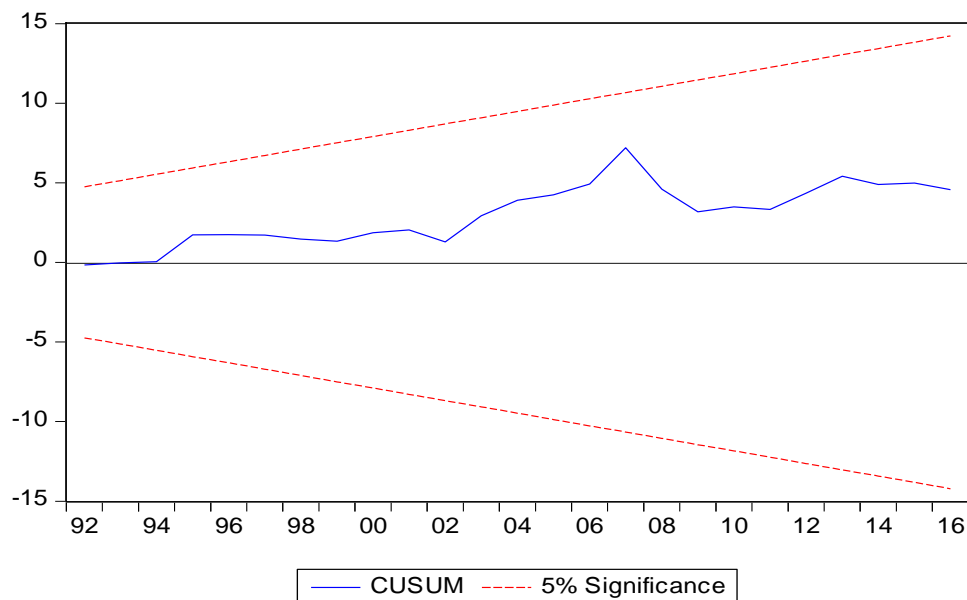


Figure 1. CUSUM Test Result.

Figure 1 presents the result of the CUSUM test that confirms that our model has no specification errors. The blue line lies perfectly between the two red lines. We therefore concluded that our model is well specified.

V. CONCLUSION

This study aims to determine whether economic growth affects capital market development in Nigeria. We found that economic growth has significant positive influence on capital market development. This means that growth of the economy has positive transmission effect on the Nigerian capital market. We also found that inflation has significant negative impact on the capital market. Rising inflation could therefore hinder capital market development. Money supply on the other hand was found to have no significant effect on the dependent variable. We detected a slow speed of adjustment toward long-run equilibrium. We conclude that economic growth is a critical driver of capital market development in Nigeria. And were recommend that policies aimed at facilitating economic activities should be pursued by the monetary authorities, the government and policymakers as this will ultimately translated to a more robust and development capital market.

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